Statement by Assistant Secretary for Economic Policy Karen Dynan for the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association

October 31, 2016

The U.S. labor market remains strong, and economic growth looks to have picked up in the second half of this year. In the third quarter of 2016, payroll growth continued to be robust, and the unemployment rate averaged 4.9 percent, compared with a pre-recession norm of 5.3 percent. Meanwhile, real GDP expanded at an annual rate of 2.9 percent, up from an increase of 1.4 percent in the second quarter. Ongoing gains in consumer spending and a jump in exports supported GDP growth in the third quarter; business inventory investment made a moderate contribution to growth after being a significant drag over the preceding year. Some key domestic fundamentals continue to be very favorable, including income growth, household balance sheets, and consumer confidence. All told, the available information suggests that the economy is on track for solid GDP growth in the quarters ahead.

GDP Growth

Real GDP increased at an annual rate of 2.9 percent in the third quarter after rising at an annual rate of 1.4 percent in the second quarter. Consumer spending continued to be a significant contributor to GDP growth in the third quarter, with real personal consumption expenditures up at an annual rate of 2.1 percent following a very strong gain in the second quarter. Consumption has been boosted over the last couple of years by a variety of factors, including robust growth in jobs and real income, low household debt burdens, increases in asset prices, and generally high consumer confidence. Exports were also a bright spot in the third-quarter GDP report, rising at an annual rate of 10 percent, due in part to a large increase in agricultural exports.

Business fixed investment remained subdued on the whole in the third quarter posting a modest gain. Investment was held down by a continued pullback in equipment purchases, which fell at a 2.7 percent annual pace. However, investment in intellectual property products continued a trend of solid growth, rising at a 4 percent pace, which bodes well for future productivity growth. And, spending on nonresidential structures increased at a 5.4 percent pace, the highest growth rate in more than two years. Structures spending had been held down by a contraction in oil drilling in the wake of the plunge in oil prices, but drilling activity appears to have bottomed out in the spring.

Business inventory investment boosted real GDP growth by 0.6 percentage point in the third quarter after subtracting 1.2 percentage points from growth in the second quarter. Inventory investment had been a drag on growth for more than a year, as firms did less stockbuilding in order to bring their inventory levels into better alignment with underlying demand. However, the drag from inventory investment appears to now be over.

Meanwhile, residential investment fell at an annual rate of 6.2 percent in the third quarter. Residential construction also dropped in the second quarter, but the declines appear to partly reflect payback after an unseasonably warm winter pulled some activity forward. Looking ahead, housing demand should be supported by continued low interest rates and favorable household financial conditions; accordingly, confidence among homebuilders remains robust.

On net, government spending made a small positive contribution to growth in the third quarter. A modest decline in state and local spending was more than offset by a moderate increase in federal spending.

Labor Markets

Since the beginning of 2016, job growth has averaged 178,000 per month. This pace is lower than the 229,000 monthly pace seen in 2015, but more than ample to keep the unemployment rate low and stable given current demographics. In the third quarter, payrolls expanded at an average pace of 192,000 and the unemployment rate averaged just under 5 percent, less than half of the peak unemployment rate seen in 2009. While the unemployment rate is now below its pre-recession average of 5.3 percent, some other measures of labor market utilization remain a bit elevated. Most notably, although the share of the labor force working part time for (involuntary) economic reasons, at 3.7 percent, is well below its recession peak, it is above its pre-recession average of about 3 percent.

The labor force participation rate rose 0.2 percentage point over the third quarter and is up 0.5 percentage point from its low point last fall. Although the participation rate is down about 3 percentage points from its pre-recession range, the lion's share of the decline appears to be attributable to retiring baby boomers.

Labor market indicators for the fourth quarter look strong. In particular, initial jobless claims are hovering near their lowest levels in more than 40 years. October payroll data will be released this coming Friday.

Wages

Nominal wage and compensation gains are picking up. Nominal hourly earnings for all private-sector employees rose 2.6 percent over the year ending in September 2016, a pickup from the roughly 2 percent pace seen earlier in the recovery. The Employment Cost Index for wages, salaries and benefits in private industry rose 2.3 percent over the year ending in September, up from 1.9 percent over the year-earlier period.

Given the pickup in wage gains, the strength in hiring, and low rates of inflation, aggregate real disposable personal income has been growing at a healthy clip for the last several years. Data from the Census Bureau released in September suggests that the gains were broad-based in 2015 (the last available reading). Real median household income increased 5.2 percent in 2015, a gain of nearly $2,800 from the previous year. The increases reached all race, ethnicity, and income groups and were highest at the low end of the income distribution.

Prices

Consumer price inflation remains low. The Consumer Prices Index (CPI) for all items increased 1.5 percent over the year ending in September, after being flat over the preceding 12 months. Despite increases in energy prices in recent months, energy prices are still down 2.9 percent on net over the year ending in September, with gasoline prices 6.5 percent below their year-earlier level. Food prices edged down 0.3 percent over the past 12 months, the first year-over-year decline since early 2010. Excluding food and energy, the CPI was 2.2 percent higher this September than a year ago, up from a 1.9 percent rise over the year-earlier period.

The Personal Consumption Expenditures (PCE) price index also shows subdued consumer inflation, with a 1.2 percent gain in the year ending in September 2016, compared with 0.2 percent in the year-earlier period. Core PCE prices show year-over-year growth of 1.7 percent over the year ending in September, up from a 1.4 percent increase over the year ending in September 2015.

Conclusion

The U.S. economy continues to perform solidly. The unemployment rate is low, payroll gains remained robust through September, and GDP growth picked up to an annual rate of 2.9 percent in the third quarter. The available indicators and information about economic fundamentals suggest that these favorable conditions will continue in quarters to come.